

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:9- PLR-148247-01

Date:

July 9, 2002

Re:

LEGEND

Decedent	=
Spouse	=
Company	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Private Letter Rulings	=

New Trusts	=
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Testamentary Trusts	=
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Will =

Dear Sir:

This is in response to your letter dated September 6, 2001, and subsequent correspondence, in which you requested rulings regarding the tax consequences of proposed modifications in the method of removing and replacing the trustees of Testamentary and New Trusts under §§ 2601, 2041, and 2514 of the Internal Revenue Code.

The facts and representations submitted are summarized as follows. Decedent died on Date 1. Under the terms of Decedent's Will, nine Testamentary Trusts were created for the benefit of Decedent's two daughters and seven granddaughters. Article IX of Decedent's Will appointed three individual trustees for these Testamentary Trusts. Article XII of Decedent's Will deals with the selection and removal of trustees.

Decedent's Will provides that the Testamentary Trust created for each of Decedent's daughters will continue for the life of each daughter and upon a daughter's death, the trust corpus is to be distributed equally to the remaining Testamentary Trusts and/or to the beneficiaries of any Testamentary Trust that has terminated. Each of the seven Testamentary Trusts created for Decedent's granddaughters will continue for the life of each granddaughter. Upon a granddaughter's death, if a granddaughter is survived by descendants under age 21, the trust property is to be held in further trust and distributed to the granddaughter's descendants free of trust upon turning age 21. If a granddaughter dies without issue, then the trust is to be divided and distributed in the same manner as the two Testamentary Trusts for Decedent's daughters.

Under the terms of Decedent's Will, the trustees are to pay or apply for the benefit of each Testamentary Trust's beneficiary so much of the net income deemed adequate to maintain and support such beneficiary in the standard of living to which such beneficiary is accustomed. Further, where the beneficiary is a minor or a student, the trustees shall provide for his or her education, as well as maintenance and support. The trustees are not authorized to distribute the Testamentary Trusts' principal.

After Decedent's death, Spouse and Decedent's estate formed Company. Each of the nine Testamentary Trusts held shares of Company stock, among other assets. Prior to September 25, 1985, on Date 2, the beneficiaries of the Testamentary Trusts obtained a court order that allowed for the formation of nine new trusts (New Trusts) to hold the stock in Company that was held in the nine Testamentary Trusts. The stock in

Company was transferred to the New Trusts and the shareholders of Company elected to treat Company as a subchapter S corporation under § 1361. The New Trusts have since elected to be treated as qualified subchapter S trusts under § 1361(d). The current shareholders of Company are daughters, granddaughters, and the New Trusts.

The court order directing the formation of the New Trusts provides that the trustees of the New Trusts are the same as the trustees of the Testamentary Trusts and that the procedures for appointing successor trustees for the New Trusts are the same as the procedures for appointing successor trustees for the Testamentary Trusts. The court order further provides that the terms of the New Trusts are identical to the terms of the Testamentary Trusts, except to the extent necessary to allow the New Trusts to be eligible holders of subchapter S corporation stock. The court order also provides that: (1) all of the net income of a New Trust must be distributed to the lifetime beneficiary of that trust at least annually; and (2) the trustees are required to invade principal to the extent that the net income is inadequate to pay the federal and state income taxes payable by the beneficiary as a result of the inclusion in the beneficiary's gross income of income attributable to subchapter S corporation stock held in the New Trust. It has been represented that principal has never been invaded to satisfy a beneficiary's tax obligation.

On Date 2, Spouse and New Trusts executed a shareholders' agreement. The terms of the shareholders' agreement provide for the annual distribution of cash dividends in an amount not less than the product of: (i) the highest marginal tax rate applicable to individual taxpayers under the Code; and (ii) the net income of Company for the preceding fiscal year. It has been represented that the shareholders' agreement has never been modified. The shareholders' agreement contains provisions requiring successive holders of Company stock to be subject to its provisions.

On Date 3, one of Decedent's granddaughters died without issue. Pursuant to the terms of Decedent's Will and the court order, the deceased granddaughter's New Trust and Testamentary Trust terminated and the assets were added in equal shares to the eight remaining New Trusts and the eight remaining Testamentary Trusts.

On Date 4, the Testamentary Trusts' beneficiaries obtained an order clarifying and interpreting the Testamentary Trusts' terms. The judicial construction was limited to clarifying the issue of excess annual income and modifications related to the administration of the Testamentary Trusts. The Service issued Private Letter Rulings to the Testamentary Trusts ruling, in part, that the court construction and modifications did not affect the grandfathered status of the Testamentary Trusts.

On Date 5, the beneficiaries of the Testamentary and New Trusts filed a petition seeking to modify the terms of the court order establishing the New Trusts and restate Article XII of Decedent's Will dealing with the selection and removal of trustees. The modifications set forth in the petition generally provide, in pertinent part, as follows.

Instead of three trustees acting for all of the Testamentary and New Trusts, each daughter and granddaughter would be required to select one corporate trustee to act as trustee of her Testamentary and New Trust. In addition, each daughter and granddaughter would also have the option to select no more than one individual to act as a trustee for her Testamentary and New Trust.

During daughters' lifetimes the corporate trustee and individual trustee, if any, of their Testamentary and New Trusts are required to be the same and the daughters are required to act together to remove these trustees and appoint successor trustees. A granddaughter, however, can act independently in appointing and removing a corporate trustee and an individual trustee, if desired, to act as trustee or trustees for her Testamentary and New Trust. In addition, in the event a granddaughter dies leaving descendants under age 21, the granddaughter may designate an individual or individuals to occupy the position of Trust Appointor who would have the authority to appoint and remove the corporate trustee and the individual trustee, if any, for any trust established for these descendants. Daughters, granddaughters, and Trust Appointors are not permitted to select a descendant of Decedent, or a spouse, or former spouse, of any descendant of Decedent to act as trustee for any trust.

It has been represented that there have been no additions (actual or constructive) to the Testamentary and the New Trusts after September 25, 1985.

The following rulings have been requested:

1. The proposed modifications will not cause any of the Testamentary or New Trusts or distributions from the Testamentary or New Trusts to be subject to the generation-skipping transfer (GST) tax.
2. The proposed modifications of the Testamentary and New Trusts will not cause any beneficiary of any of the Testamentary or New Trusts to be treated as having a general power of appointment with respect to the Testamentary and New Trusts within the meaning of §§ 2041 and 2514.

RULING 1 - LAW and ANALYSIS:

Section 2601 provides that a tax is imposed on every generation-skipping transfer.

Section 2611 provides that the term "generation-skipping transfer" means a taxable termination, a taxable distribution, and a direct skip.

Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (the Act) and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provide that the GST tax provisions of chapter 13 will not apply to any generation-skipping transfer under a trust

that was irrevocable on September 25, 1985. However, this exemption does not apply if additions (actual or constructive) are made to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(ii)(A) provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in § 26.2601-1(b)(ii)(B) or (C) (relating to property includible in a grantor's gross estate under §§ 2038 and 2042).

Section 26.2601-1(b)(1)(iv) provides that if an addition is made after September 25, 1985, to an irrevocable trust that is otherwise exempt from the application of chapter 13 by section 1433(b)(2)(A) of the Act, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13. Section 26.2601-1(b)(1)(v)(A) describes "constructive" additions to trusts in certain situations involving powers of appointment and relief from liability.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax under § 26.2601-1(b)(1), (2), or (3) (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. The rules contained in § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(D)(1) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy § 26.2601-1(b)(4)(i)(A), (B), or (C)) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Section 26.2601-1(b)(4)(i)(D)(2) provides that for purposes of § 26.2601-1(b)(4)(i)(1), a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be

immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust.

In the present case, the Testamentary and New Trusts were created and became irrevocable prior to September 25, 1985, and you have represented that no additions, actual or constructive, have been made to the Testamentary and New Trusts after that date. Accordingly, the Testamentary and New Trusts are exempt from the GST tax under § 26.2601-1(b)(1).

Based upon the information submitted and the representations made, the proposed modifications are administrative in nature and do not shift a beneficial interest in any Testamentary or New Trust to a person or persons who occupy a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification. Further, the modifications will not extend the time for vesting of any beneficial interest in the Testamentary or New Trusts beyond the period provided for prior to the modifications. Accordingly, based upon the information submitted and representations made, we conclude that the proposed modifications to the Testamentary and New Trusts will not constitute an addition to the Testamentary or New Trusts, or otherwise subject those trusts, or distributions from those trusts to the GST tax. Further, the proposed modifications will not cause the Testamentary or the New Trusts to lose their GST tax exempt status.

RULING 2- LAW and ANALYSIS:

Section 2041(a)(2) provides that the value of the gross estate shall include the value of all property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under §§ 2035 to 2038, inclusive.

A general power of appointment is defined in § 2041(b)(1) as a power that is exercisable in favor of the individual possessing the power, his estate, his creditors, or the creditors of his estate. Under § 2041(b)(1)(A), a power to consume, invade, or appropriate property for the benefit of the decedent relating to the health, education, support, or maintenance of the decedent shall not be considered a general power of appointment.

Section 20.2041-1(b)(1) of the Estate Tax Regulations provides, in part, that if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and

appoint any other person including himself, the decedent is considered as having a power of appointment.

Section 20.2041-1(c)(1) provides, in part, that the term "general power of appointment" as defined in § 2041(b)(1) means any power of appointment exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate, except: (i) joint powers, to the extent provided in §§ 20.2041-2 and 20.2041-3; and (ii) certain powers limited by an ascertainable standard, to the extent provided in § 20.2041-1(c)(2). A power of appointment exercisable for the purpose of discharging a legal obligation of the decedent or for his pecuniary benefit is considered a power of appointment exercisable in favor of the decedent or his creditors.

Section 20.2041-1(c)(2) provides that a power to consume, invade, appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is, by reason of § 2041(b)(1)(A), not a general power of appointment. A power is limited by such a standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). As used in this subparagraph, the words "support" and "maintenance" are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Examples of powers which are limited by the requisite standard are powers exercisable for the holder's "support," "support in reasonable comfort," "maintenance in health and reasonable comfort," "support in his accustomed manner of living," "education including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses of invalidism." In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

Section 2514 provides for a similar definition of a general power of appointment for gift tax purposes, and § 25.2514-1(c)(2) of the Gift Tax Regulations contains provisions similar to § 20.2041-1(c)(2). Section 2514(b) provides that the exercise or release of a general power of appointment created after October 21, 1942, shall be deemed a transfer of property by the individual possessing such power.

With respect to the Testamentary Trusts, the proposed modifications to Article XII of Decedent's Will will not cause the Testamentary Trusts' beneficiaries to have a general power of appointment over the Testamentary Trusts because the trustees' power to distribute net income from each Testamentary Trust to a beneficiary is limited by an ascertainable standard pursuant to §§ 20.2041-1(c)(2) and 25.2514-1(c)(2). In addition, the trustees of the Testamentary Trusts do not have the power to distribute principal to the Testamentary Trusts' beneficiaries. Accordingly, the proposed modifications will not cause the Testamentary Trusts' beneficiaries to have a general power of appointment over the Testamentary Trusts within the meaning of §§ 2041 and 2514.

In the present case, the trustees of the New Trusts are required to distribute all of the

net income of each New Trust at least annually to the trust's beneficiary. In addition, they are required to invade principal to the extent that the net income of the New Trust is inadequate to pay the federal and state income taxes payable by the beneficiary as a result of the inclusion in the beneficiary's gross income of income attributable to any subchapter S corporation stock held in the New Trust. Company's shareholders' agreement, however, was executed on the same day that the New Trusts were created and generally provides for annual distributions of cash dividends sufficient to cover the beneficiary's tax liability attributable to the income of Company.

In this case, the trustees of the New Trusts have no discretion over the payment of income. Further, Company's shareholders' agreement provides for distributions sufficient to cover a shareholder's tax liability attributable to their share of Company's income (distribution provision) and you have represented that the principal of the New Trusts has never been invaded to satisfy a beneficiary's tax obligation. Accordingly, the New Trust provision requiring the invasion of principal to pay a beneficiary's taxes attributable to subchapter S corporation stock in a year the New Trust's income is insufficient to satisfy the beneficiary's tax obligation is ineffective and superfluous, provided the distribution provision in Company's shareholders' agreement remains in effect. Accordingly, provided that the distribution provision in Company's shareholders' agreement remains in effect and is not modified, the proposed modifications will not cause the beneficiaries of the New Trusts to have a general power of appointment over their New Trust within the meaning of §§ 2041 and 2514. This ruling is expressly limited to the New Trusts during the period Company stock is the only S corporation stock held in each New Trust.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,
Melissa C. Liquerman
Branch Chief, Branch 9
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure

Copy of this letter for § 6110 purposes

cc: